

# Economic Policy Review

October 2004

© IME [www.ime.bg/en/index.html](http://www.ime.bg/en/index.html)

## In the issue

**Record High Budget Surplus – Time to Cut Taxes**

**Good News from the Balance of Payments**

**Higher Capacity via Administration Reform**

**New Europe: Low Taxes or German Taxes?**

**Global and Regional Factors Influencing Bulgarian Real Estate Prices**

**NGO Letter to the FAO**

**We Recommend: Tax Calculator**

## **Record High Budget Surplus – Time to Cut Taxes**

*Georgi Angelov*

In the beginning of October the Ministry of Finance released the latest information for the execution of the consolidated government budget. According to the ministry the revenues are 10.3 billion leva and expenditures are 9.1 billion leva. The budget surplus is about 1.2 billion leva (600 million euro) for the period January – August 2004. As a share of GDP the budget surplus is about 3%.

The budget surplus is a result of two factors. First, there are delayed and economized expenditures for about 300 million leva. Second, there are about 900 million leva (450 million euro) more revenues in the budget than expected.

The excess revenues will continue to increase and will most probably reach 1.2 – 1.5 billion leva till the end of the year (see table 1). A realistic forecast is 1.3 billion leva excess revenues for 2004. In 2003 the excess revenues were 700 million leva.

**Table 1: Forecast for the excess revenues in the budget for 2004**

Forecast	Revenue growth	Excess revenues for 2004 (billion leva)
Forecast of IMF	3% of GDP	1.139
Keeping the growth of cumulative revenues for the last 13 months	11.3%	1.248
Keeping the growth of revenues	12.6%	1.427
Keeping the average monthly growth of revenues for the last 12 months	13%	1.484
<b>Average</b>		<b>1.325</b>

## **What can be done with 1.3 billion leva?**

In 2004 some of the excess revenues will be spent and others will be saved by the government. There are several alternatives for 2005:

- The personal income tax can be lowered to zero (it is between 12% and 29% now);
- The corporate tax can be cut to zero (it is 19.5% now);

- It is possible to cut simultaneously the personal income tax and corporate tax to 10%;
- The social security tax can be cut from 42.7% to 22%.

All of these alternatives for tax cuts will be beneficial for the economic growth and prosperity of Bulgarian citizens.

## Good News from the Balance of Payments

*Dimitar Chobanov*

Recently, the Bulgarian National Bank (BNB) released balance of payments data for the second quarter of the year. These data are preliminary and any analysis based on them may not be precise and the conclusions made may not be absolutely correct. Anyway, as these are the only available reliable source data, we should use them.

Analyzing the balance of payments we should consider first the financial account that reflects the inflow and outflow of capital in the country. One of the most important indicators which is closely connected to the economic development of the country is the foreign direct investment (FDI). During the second quarter of 2004 its size is EUR 628.6 million and from the beginning of the year it is total EUR 978.6 million. These values are historically high during the period balance of payments data series are collected and represent over 5% of Agency for Economic Analysis and Forecasting projected gross domestic product (GDP) for 2004. The positive development of FDI is confirmed by the estimations of the Bulgarian Investment Agency, which stated that FDI inflows would reach USD 2 billion until the end of 2004. Probably, this forecast may be exceeded if the privatization of electro redistribution companies is completed as it is planned.

Of course, it should be mentioned that FDI reporting is not correct enough as it includes privatization receipts. Actually, the privatization is not an investment but it is only a change in ownership of particular property to a foreign resident. It is natural to expect that this property transfer will generate real investment in the country but with a lag and the size of this subsequent investment would differ from privatization price that is reported in the official statistics. For example, the Bulgarian Telecommunication Company sale was made in the second quarter and contributes significantly to the increase of the direct investment in equity recorded in the latest data.

As a whole, the financial account balance for the first half of the year reaches EUR 1469.6

million, which is a growth of 48% compared to the same period in 2003. Thus, the sum of current and financial account is positive with level of EUR 523.1 million.

Logically, the persistent trend of rising net capital inflows to the country causes higher levels of disposable incomes for the Bulgarian citizens and companies in foreign currency. That supposes higher demand for either locally produced or imported goods and services. As Bulgarian companies are not able to satisfy the higher demand and some items like automobiles are not produced in Bulgaria at all the import continuously rises and its growth during the period is about 17%.

Import structure is relatively stable and the share of investment goods is around 25%. However, the import of these goods increased rapidly in the second quarter of 2004 reaching EUR 1350.9 million and the growth relative to the same period in 2003 is above 111%. This indicates increased investment activity and supposes that there should be higher productive efficiency and higher competitive power on the international markets. It is possible that this could not influence the export as some part of these investment goods is used in the non-tradable sector of the economy – i.e. goods that are not object of external trade. On the other hand, cheaper or higher quality goods and services that are result of these investments would lead to higher utility and real incomes for the Bulgarian citizens and companies and they could expand their consumption or savings.

The tendency in current transfers is holding during the period and they rise to a level of EUR 351.4 million – EUR 93.6 million higher than in 2003. Money transfers from Bulgarian citizens living abroad – about 85% of all transfers, and revenues from the European Union programs – about 11%, mostly determine them.

Net income from abroad rises relative to the previous year when it was negative with EUR 320.2 million to EUR -169.2 million. The reason behind this is the smaller size of investment revenues outside Bulgaria and particularly the direct investment revenues.

Another indicator that realizes significant growth during the first half of the year are the foreign exchange reserves of the BNB. Their absolute increase is EUR 782.8 million, which is also historically high value for such period. These reserves indicate the confidence in the currency board and the fixed exchange rate of

the lev to the euro and the ability of the BNB to meet its obligations in this direction.

To summarize the above-mentioned facts and conclusions, the Bulgarian economy is running well and the balance of payments data confirm this positive tendency.

**Table 1: Main positions in the balance of payments for the first half of the year (in million of euro)**

	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Current account	-481.9	-523.4	-922	-946.5
Trade balance	-760.1	-746.9	-940.4	-1302.6
Services, net	146.1	109.2	80.9	173.9
Income, net	-143.1	-129.8	-320.2	-169.2
Current transfers, net	275.2	244.2	257.7	351.4
Financial account	153.7	1185.7	993	1469.6
Foreign direct investment in Bulgaria	487.6	646.1	651.4	978.6
Reserves and related items*	168.2	-136.9	-145.4	-749
Foreign exchange reserves of BNB*	169.9	-30.2	-300.9	-782.8

*\* Negative values mean higher foreign exchange reserves*

*Source: Author's calculations based on BNB data*

## **Higher Capacity via Administration Reform**

*Martin Dimitrov*

According to last statements of politicians Bulgarian administration's capacity needs strengthening through hiring additional state employees. It is a conventional opinion that EU accession requires extra high skilled personnel to deal with the 'acquis communautaire'.

Following NSI data, additional 9,484 state servants have been employed for the period January-June 2004 under job assignments 'State Management'. Therefore, their number at the end of the period reached 121,244. If envisaging all organizations and funds financed by the budget the number of employees increased from 437,212 to 458,316 from January to June 2004. The average gross salary for the second quarter of 2004 for the job position –'State Management' is 405 BGN (203 euro) and for all other state funds and organizations the average gross salary is 305 BGN (153 Euro). The active population in Bulgaria is 3.376 million, meaning that employees receiving salaries through the budget are 13.5%.

The adoption of EU legislation framework is a very complicated process requiring high qualification, good experience and foreign languages proficiency. The last enlargement of EU (envisaging the 12 countries) took place at significant difference in economic condition of the new members (or candidate-members) towards the average levels of EU. Despite this, the European legislation framework, which has to be adopted is far more larger and complicated in comparison with the former enlargements of the Community.

Decisions taken by state officials have decisive importance for the costs of doing business in Bulgaria. In number of cases the European legislation framework permits certain flexibility. It is expressed either in adoption of transitional periods or through a choice of different decisions from that, applied in most countries in EU. However, it is necessary to be known exactly which directives shall be the most serious problem for local players, which means that an impact analysis is necessary. For this reasoning, IME team has many times emphasized the importance of introducing a systematic regulation impact analysis in Bulgaria as a tool for cost and benefit analyses

and selection among different alternatives. In many cases is necessary a check or a repeal of already adopted legal acts. This creates unpredictability of business environment and respectively implies additional expenditures before all existing and potential investors.

However, employees having the relevant skills could find better remuneration and working conditions within the private sector. Thus it is virtually impossible to recruit the appropriate cadres for the state administration. Nowadays, the government is trying to reinforce administrative capacity via hiring new and new employees. Though, this is not leading to better

capacity but to over employment and excessive costs for the administration.

The only reasonable solution is the narrowing of state administration to the operationally needed personnel. It would both allow significant increase of remuneration and decline of budget costs for the administration. When discussing this option politician usually say, “it is politically very difficult to fire state servants”. That is through, it is politically difficult. But without reforms, neither administrative capacity will be reinforced nor any savings in the administration budget are possible.

### **New Europe: Low Taxes or German Taxes?**

*Georgi Angelov*

In 1997 the corporate tax in Bulgaria was 40.2%. At the moment it is 19.5% and the government proposed to cut it to 15% from the beginning of 2005. The personal income tax's top rate was 40% in 1997, it is 29% now and it will be cut to 24% in 2005 according to government plans. Thus in 2005 Bulgaria will have one of the lowest profit and income taxes in Europe. Moreover, the Institute for Market Economy started a campaign for introducing a 10% flat rate for all direct taxes – corporate tax, personal income tax and social security tax. So the tax cutting in Bulgaria will most probably continue.

And Bulgaria is not an exception:

- There is a zero percent tax on the reinvested profit in Estonia
- The corporate tax in Serbia is 14% and the government proposed a cut to 10%
- In Latvia, Lithuania and Macedonia the corporate tax is 15% and Lithuanian government is considering a cut to 12.5%
- The corporate tax in Hungary is 16% and it might be cut to 12%

#### ***New Europe's Taxes***

<b>Country</b>	<b>Corporate Tax</b>
Estonia	26% (0%)
Cyprus	15% (10%)
Serbia	14%
Latvia	15%
Lithuania	15%
Macedonia	15%
Hungary	16%
Slovakia	19%
Poland	19%
Bulgaria	19.5%
Moldova	20%
Croatia	20.32%
Slovenia	25%
Romania	25%
Czech Rep.	28%

What all this shows is that tax competition is working in Central and Eastern European countries and most of them are trying to follow the successful Irish example – to have faster economic growth through low taxes and free economy.

However, there are some voices within some of the European Union's old member countries like Germany and France that are willing to stop this development toward lower taxes in the so-called New Europe. Although their political differences the ruling parties in Germany and France are against the tax competition (however, it seems

that the opposition in Germany is not supporting the government's position).

One of the stated reasons against the low taxes is something like that: *We (the old members of EU) tax our companies with high taxes and give the money to you (the new members of the EU or candidates). You use our money to cut your taxes and that is unfair competition.* Let us see if that is true.

First, countries cannot use EU funds to cut taxes, because the EU funds are designated for certain purposes (like agro subsidies for example).

Second, if we compare the corporate tax we will see that it is 38.3% in Germany and in Bulgaria it is 19.5%. It looks like Germany extracts more money from the economy through the corporate tax than Bulgaria. But the reality is different – in Germany there are so much tax exemptions (or loopholes) that a lot of companies are paying no taxes at all. In Bulgaria there are almost no exemptions.

So that it is not surprising that according to Eurostat Germany collects only 0.6% of GDP through the corporate tax. In Bulgaria the revenues from the corporate tax are about 3% of GDP. Obviously Bulgaria's lower tax rate generates more revenues than Germany's high rate with many loopholes. But this is not a problem of the Bulgarian government – it is a decision of the German government to create such a tax system and only the German government can change that system. If the loopholes are eliminated, the German government can introduce a 10% corporate tax without any loss of revenues!

At the moment the poor countries of EU receive subsidies by the richer countries through the EU budget. If the new countries follow the Irish example successfully they will become rich in a very short time so that they will stop receiving EU subsidies. Therefore it is in the self-interest of Germany (as net payer in the EU budget) to support the low taxes and economic reforms in the new members. If the new countries are forced to have high taxes they will be like

Greece. After many years in the EU Greece is still poor country and it is receiving huge amount of subsidies every year. Creating many new Irelands is the better choice for the old members of EU than creating new Greeces.

Speaking about the EU subsidies it worth noting that most of the subsidies are actually an obstacle to the economic development of the new EU members and candidate countries. The subsidies are managed by bureaucrats and they do not have incentives to spend money prudently for the general welfare. Moreover, there is a need for more bureaucrats to manage the money. The huge EU subsidies also change the incentives and direct resources toward unproductive activities. Therefore the European Union should either stop subsidizing the poor countries or it should give subsidies in exchange for economic reforms.

It is very important for the German and French governments to remember that lower taxes would increase the economic growth and thus the prosperity of the poor citizens of the former socialist countries. Therefore it would be an act of humanity for Germans and French to support the low taxes in New Europe. That will bring better results than any kind of state subsidies.

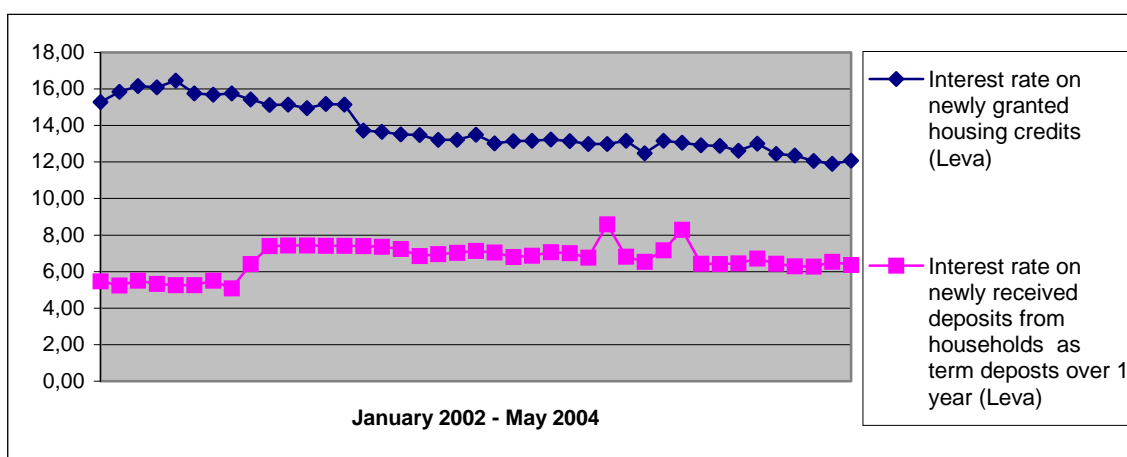
In the last several months Mr. Shroder, the left-wing German Chancellor and the Mr. Sarkozy, the French Minister of Finance that is sometimes called "follower of Thatcher" speak in the same language against the low taxes in Central and Eastern Europe. However, both of them have poor economic record compared to the former communist countries. The formerly communist East Germany has an average rate of economic growth of 1% per year. The economic growth in Bulgaria is four times higher – more than 4.4% per year and Bulgaria is not the best example. Estonia and Latvia's economies grew by 5.5-6% per year. It seems that the French and German governments should start learning from the New Europe's recent economic experience and stop giving advices about the tax policy.

## Global and Regional Factors Influencing Bulgarian Real Estate Prices

Svetla Kostadinova

If you compare the average salary in the country and market real estate prices you will be surprised that a real estate market exists. For example, the two-room apartment price in June 2002 was on average 102 wages and you would need 235 average wages in July 2004. The difference is obvious but not so hard to be explained. Why real estate prices are so high?

- Banks compete in housing credits. **Interest rates had fallen** to 12.08% as



Source: BNB

- Demand for real estate properties is growing because of the **easier access to financial resources** and due to invasion of foreign investors and companies. Globalisation is irreversible process and Bulgaria is experiencing both negative and positive effects. Rising of real estate prices is happening throughout the world. For example, real estate market in USA is experiencing 59 per cent rise of offshore capital inflows in housing sector since 2002. Bulgaria has a lot to do before being attractive and competitive for such investors. A lot remains to be done in the area of property rights, land market, stability and security, development of local financial market. A positive step in facilitating access to financing is reforming and putting into operation of the central credit register within the

of May 2004 according to Bulgarian National Bank statistics. There were some complaints by customers who were cheated by some banks on lower interest rates and were forced to pay hidden expenses on credit servicing. The regulator's response was preparation of draft bill on consumer credits that will oblige banks to give reliable information to consumers in order to assess the bank contract conditions objectively. There is a chance that mortgage credits granted to individuals and small companies be included in the law.

Central bank and finalizing the organizational stage of the *first private credit bureau* in the country (it is expected that it will start till the end of 2004).

- **Outsourcing to East.** The process of outsourcing of production to the East because of the cheaper and qualified labour force is speeding up and affects the economy. Foreign companies are entering the national market and creating demand for office space and industrial land. Creation of working places, investment in new technologies and importing of know-how creates positive effect on Bulgarian economy.
- Concluding **EU accession** negotiations and forthcoming membership often is pointed as a reason for rising real estate



prices. This process will probably continue and the question is until when. Doubtless, the future EU membership will raise security to international companies when deciding on settling in the country and in certain cases their attitude is determined by real estate profitability. This is especially true for office buildings where profitability is defined as correlation between rent and selling price. At the moment, the profitability in Bulgaria is relatively high but this was also the case in the

new EU members that registered drop after accession.

- ❑ **Location.** Bulgaria location matters significantly to future development and prospects. Country's strategic location in respect of European and Asian markets can easily turn Bulgaria in important and leading logistic centre in the region. The prerequisites are stable economic environment that will ensure predictability and will attract long-term investments requiring huge real estate acquisitions and rentals.

---

### NGO Letter to the FAO<sup>1</sup>

NGOs in support of [FAO report](#), "Agricultural biotechnology: meeting the needs of the poor?"

An open letter to Mr. Jacques Diouf, Director General of UN Food and Agriculture Organization

*July 16, 2004*

Mr. Jacques Diouf  
Director General  
UN Food and Agriculture Organization  
Geneva, Switzerland

Dear Mr. Diouf,

We, the undersigned NGOs and civil society stakeholders involved in farming and agricultural issues, wish to express our support and agreement with the FAO report released Monday, May 17 ("Agricultural biotechnology: meeting the needs of the poor?").

We applaud the FAO for moving the discussion about agricultural biotechnology away from polarizing political rhetoric and either/or debates toward how best to utilize and apply agricultural biotechnology to the needs of the world's poor and undernourished. This is a most welcome advancement of the international discussion.

The FAO is to be commended for its balanced, well-reasoned approach. The report acknowledges that while there are potential risks

from the use of agricultural biotechnology, the potential benefits are both large and greatly needed given the challenges humanity faces in feeding a larger, more affluent population from an already limited land and resource base.

Far from proposing a "technological fix" to food security problems, the report acknowledges that biotechnology alone cannot solve the problems of the poor and that a multifaceted approach is needed to address systemic poverty and malnutrition in developing regions. The report also stresses the need to carefully assess the socio-economic, food safety, and environmental impacts of biotechnology on a case-by-case basis, considering both the opportunities and risks.

Importantly, the report acknowledges that biotechnology offers tremendous promise in increasing food security, food safety, and economic opportunities for smallholder farmers in developing countries. Biotechnology can speed up conventional breeding, address intractable disease problems, create crops that resist disease and insect pests and displace toxic chemicals that harm the environment and human health, help combat difficult endemic livestock diseases, and improve the nutritional quality of dietary staples heavily relied upon by the poor. Because the technology is embodied in the seed, these may be easier for small-scale, resource-poor farmers to utilize than the technologies of the previous and successful Green Revolution.

While currently led by the private sector and focused on developed countries in the West, the report notes that there are critical opportunities ahead for biotechnology to address the particular

---

<sup>1</sup> The list of people who signed the letter can be seen at:  
<http://www.internationalconsumers.org/faoletter.htm>

needs of the poor and that cooperation and adequate funding are needed to ensure that the needs of the poor are not neglected and barriers to access are overcome.

Noted in the report are public-private partnerships, increased funding for public-sector transgenic crop research, and technical and regulatory capacity building in developing countries to ensure they have the skills and knowledge necessary to make their own decisions about the use of biotechnology.

The report notes that the emerging evidence on the economic impacts of transgenic crops for smallholders is positive, with enhanced incomes and reduced pesticide exposure.

Finally, the report highlights some of the difficult agricultural and nutritional problems

faced by smallholders in developing countries, and the unique and powerful ways that agricultural biotechnology can address these issues.

Perhaps most importantly, this FAO report acknowledges the food safety of transgenic products currently on the market. The report stresses that regulation should be science-based and noted the critical role of the Codex Alimentarius Commission and International Plant Protection Convention in easing international tensions in trade and food aid.

We commend the FAO and your office for weighing in on this important yet still contentious area and offering reasoned optimism about the role that agricultural biotechnology should play in meeting the needs of the poor and humanity in the 21st century.

---

### **We Recommend**

Please visit our website to access the [Tax Calculator](#) for the three tax proposals from *National Movement Simeon II*, *Union of Democratic Forces* and *Democrats for Strong Bulgaria*.

---

**Institute of Market Economics, Bulgaria**  
*Angelov, Chobanov, Dimitrov, Kostadinova, Stanchev*

For comments and recommendations: [svetlak@ime.bg](mailto:svetlak@ime.bg)

**Web address:** [www.ime.bg/en](http://www.ime.bg/en)

**Contacts:** Phone/Fax: ++ 359 2 / 944 71 19, 943 36 48